IN THE

Supreme Court of the United States

OCTOBER TERM, 1944.

No. ———

A. G. HORTON and M. K. BUCHANAN, Trading as Mechanical Ice Tray Company and I. C. E. Corporation, *Petitioners,*

v.

GENERAL MOTORS CORPORATION, *Respondents.*

BRIEF IN SUPPORT OF PETITION.

OPINIONS OF THE COURTS BELOW.

The opinion of the District Court for the Southern District of New York is unreported but appears at pages 258 to 288 of the record. The opinion of the Second Circuit Court of Appeals appears at pages 330 to 344 of the record and is reported in 144 F. (2d) 720.

STATEMENT OF THE CASE.

The pertinent facts are sufficiently stated in the petition and will not be repeated. The pertinent portion of the majority opinion of the Court of Appeals is at pages 337 to 341 of the record (144 F. 2d 724 to 727), and the dissenting opinion of Judge Frank is at pages 341 to 343 of the record (144 F. 2d 727 to 728).

SPECIFICATION OF ERRORS.

The errors which Petitioners will urge, if the writ of certiorari is allowed, are that the Circuit Court of Appeals erred:

1. In holding that respondent was relieved of its obligation to exploit the licensed patents in good faith by paragraph Eleventh (b) of the agreement.
2. In holding that respondent's sale of unlicensed substitutes (trays type 2, 3, 4,) instead of licensed trays was not a breach of its obligation to exploit the licensed patents in good faith, entitling the petitioner to damages therefor.
3. In reversing the decree of the district court sustaining petitioner's right to damages by reason of defendant's substitution of type 4 tray for the patented type 7 tray.

SUMMARY OF ARGUMENT.

1. The Court of Appeals was clearly in error in finding an agreement that any royalty-free product could be sold without regard to the implied covenant of good faith, and in refusing to give effect to the implied covenant in the case of this licensee's royalty-free products, assuming for this purpose that the implied covenant is not repugnant to the *Mercoid* case.

2. The Court of Appeals was in error in thinking that the implied covenant is repugnant to the *Mercoid* case.

3. The abrogation of the implied covenant on either ground is a matter of general importance in the administration of the patent law, especially affecting the use of patents and the policy of the law to promote the use of inventions.

ARGUMENT.

I.

The Court of Appeals was clearly in error in finding an agreement that any royalty-free product could be sold without regard to the implied covenant of good faith, and in refusing to give effect to the implied covenant in the case of this licensee's royalty-free products, assuming for this purpose that the implied covenant is not repugnant to the *Mercoid* case.

The well established rule that an exclusive licensee is under an implied covenant to exploit the patented trays in good faith, and to refrain from entering into competition with the patented device for its own profit and to the detriment of the licensor, is recognized by the Court of Appeals (R. 337-40; 144 F. (2d) 724-6). Its statement shows that the rule is one of general application to all situations involving co-adventurers.

> "The second cause of action is based on the duty of an exclusive licensee on the unit royalty basis to exploit in good faith and its alleged breach. The theory of that cause of action is that the productiveness of the licensor's property having been placed solely within the control of the licensee, a covenant on its part to work the patent in good faith to make it produce royalty income will be implied.
>
> "The principle is well established with respect to a wide variety of contracts in which the consideration for a grant of property lies wholly in the payment of 'sums of money based upon the earnings of the property transferred.' *In re Waterson, Berlin & Snyder Co.*, 2 Cir., 48 F. (2) 704, 709. It has been applied in the case of such diverse transactions as the granting of the exclusive right to place the licensor's endorsement of approval on the dress designs of others (*Wood* v. *Lucy, Lady Duff-Gordon*, 222 N. Y. 88, 118 N. E. 214), to quarry stone (*Stoddard* v. *Illinois Improvement Ballast Co.*, 275 Ill. 199, 113 N. E. 913), *Ellis* v. *Swan*, 38 R. I. 534, 96 Atl. 840), to sink and operate oil wells (*Harris* v. *Ohio Oil Co.*, 57 Ohio St. 118, 48 N. E. 502), to trans-

port cargoes (*Great Lakes & St. Lawrence Transportation Co.* v. *Scranton Coal Co.*, 7 Cir. 239 F. 603), to mine gold (*Pritchard* v. *McLeod*, 9 Cir., 205 F. 24), and to exploit a musical composition (*In re Waterson, Berlin & Snyder Co., supra*). And see, *Dwight & Lloyd Sintering Co.* v. *American Ore Reclamation Co.*, D. C. 44 F. Supp. 391. It has been held that such a contract includes an implied negative covenant that 'neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract.' *Uproar Co.* v. *National Broadcasting Co.*, 1 Cir., 81 F. (2d) 373, 377, cert. den. 298 U. S. 670.

"In a number of cases an express covenant to exploit a patent has been enforced against an exclusive licensee. See *Neenan* v. *Otis Elevator Co.*, 2 Cir., 194 F. 414; *Crowe* v. *Oscar Barnett Foundry Co.*, D. C. 213 F. 864, modified 3 Cir., 219 F. 450; *Carbo-Frost, Inc.* v. *Pure Carbonic Inc.*, 8 Cir., 103 F. (2) 210, cert. den. 308 U. S. 569; *Matzka Corp.* v. *Kelly Dry-Pure Juice Corp.*, 19 Del. Ch. 359, 168 Atl. 70; *DeStubner* v. *Microid Process, Inc.*, 121 W. Va. 773, 6 S. E. (2) 777.

* * * * * * * * *

"There is one well recognized exception to the doctrine as it has previously been applied. That is where there is outside competition which the exclusive licensee cannot meet with reasonable chance of success with the licensed article. *Eclipse Bicycle Co.* v. *Farrow*, 199 U. S. 581; *Carbo-Frost, Inc., supra; Briggs* v. *United Shoe Machinery Corp.*, 92 N. J. Eq. 277, 114 Atl. 538. If such competition comes from something not commercially better than the licensed device he must meet it by means of the latter. If he sees fit to overcome the competition by purchasing the right to make the completing article, he cannot substitute the latter for the licensed device without thereby violating his covenant to exploit so long as he retains an exclusive license. But if the competition comes from a better article than the one licensed, he is under no obligation to try with no hope of success to meet it with the licensed device. Compare, *Parev Products* v. *I. Rokeach & Sons*, 2 Cir., 124 F. (2) 147. Faced with such a business situation he may, if he can, obtain and exercise the right to make

> or use the competing article without violating any obligation to exploit under his exclusive license. *Eclipse Bicycle Co.* v. *Farrow, supra; Carbo-Frost Inc.* v. *Pure Carbonic, Inc., supra.*"

In the case of *Underhill* v. *Schenck,* 238 N. Y. 7, Judge Cardozo of the New York Circuit Court of Appeals stated the proposition in these words (p. 13):

> "This fiduciary relation charged the fiduciary with a duty to refrain from forms of competition involving unfair diversion of royalties or profits. The position of such a one is analogous in this respect to the position of a partner. What he gains from a competing business, if the competition is so close as to transcend the bounds of fairness, he is not to keep for himself, but is to surrender to the joint adventure (*Trimble* v. *Goldberg,* 1906, A. C. 494, 500; *Aas* v. *Benham,* 1891, 2 Ch. D. 244, 255; *Latta* v. *Kilburn,* 150 U. S. 524, 549; *Beatty* v. *Guggenheim Exploration Co.,* 225 N. Y. 380, 386; cf. *Cescinsky* v. *Routledge & Sons, Ltd.,* 1916, 2 K. B. 325)."

The one fact which illuminates the purpose of the implied covenant is that we are dealing with an exclusive license. The presently significant incident of such a license is that it excludes the licensor himself both from the practice of the invention and from any opportunity to exploit the invention by licensing others. That exclusiveness, so valuable to the license while he is establishing his business, contains the possibility that the licensee will play "dog in the manger" after he has become established and will turn to some unlicensed substitute evolved in the meantime which is no better than the patented thing but is capable of replacing it in the market. In that event, the licensee would keep his exclusive position, and extend it even to the exclusion of his licensor, without paying any royalty. That possibility—here the reality—creates the need for the covenant to exploit, with its implementing obligation to compensate the licensor if the licensee fails to do so while still exclud-

ing the licensor from his opportunity to exploit otherwise.[6a]

Primarily the covenant is an affirmative one to exploit the patented thing and a negative covenant that the licensee will not sell unlicensed substitutes—which would deprive th elicensor of royalty—unless such sale is justified by a competitive necessity. That justification for selling a royalty-free product arises when a competitor puts out a superior product with which the patented product would not successfully compete. But the licensee is not limited to that justification; he may anticipate competition and advance his interest and that of the public by changing to a non-infringing product superior to the patented one. The principle and its limitation therefore protect both parties and the public. All it imposes on the licensee is an obligation not to sell products that are commercially equivalent to the patented product or, in other words, products that are no better in competition but merely different in ways that avoid the licensed patents and the royalty obligation, and the sale of which would have only the effect of cutting off the licensor's income while leaving him powerless to exploit the patented thing himself or through others.

The incident of this covenant that is of primary significance is the sanction by which it is made effective. That is an award of damages for its breach. Such damage may be measured by the royalty of which the licensor was deprived by the breach. It is to be mistaken by appearances however if one views this as a royalty on unpatented products or as an enforcement of a monopoly of them. It is altogether the enforcement of an obligation of decency which protects the

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[6a] Here the exclusive licensee had the right to surrender the exclusive license, retaining a non-exclusive license. If upon its decision to promote unlicensed trays instead of the licensed trays, respondent had surrendered its exclusive license, petitioner would have had no claim. The gravamen of the complaint is that while promoting unlicensed trays respondent still retained its exclusive license, thus preventing licensor or any one else from exploiting the licensed patents (R. 156).

licensor without adversely affecting any proper interest of the licensee or of the public.

The other chief incident of this covenant is that in all dealings between licensor and licensee it introduces a second and largely independent inquiry in the settlement of an account between them; second, that is, because the primary inquiry is posed by the express obligation to pay a royalty on all patented products sold. The second inquiry, invoking this implied covenant, arises *only* if on the first inquiry it is found that the licensee has sold a product that is not within the patent and is therefore royalty free.

The important facts to be observed are these: (1) the question of patent scope relates primarily to the first inquiry fixing the royalty obligation; (2) the second inquiry involves only a question of relative marketability, competitive justification.

The second inquiry arises only if the first reveals the sale by the exclusive licensee of an unlicensed and therefore royalty-free product. Hence, any resort to the implied covenant presupposes the sale of a product which is royalty free.

How the fact of freedom from royalty is established is immaterial—whether by agreement, by compromise, by arbitration, by litigation or by reference to some decision against a third party that is taken as definitive. Hence, in this case, paragraph "Eleventh (b)" to the extent that it applies, figures simply as one way of disposing of the first inquiry; it has nothing to do with the second. The failure to perceive the difference between these two inquiries is the root of the court's error below.

The Court of Appeals gave paragraph Eleventh (b) an effect beyond that of determining what is within or without the patent and so within or without the *royalty obligation.* It assumed that because paragraph Eleventh (b) made the trays royalty free with respect to the adjudicated patent, the parties must have impliedly agreed that the licensee could make and sell these trays, even though such conduct

would otherwise involve a breach of the *implied obligation* of good faith.[7] But to imply a freedom to make and sell from the fact that the product is free of the express royalty obligation is to abrogate the implied covenant to exploit. For it is not until it is made to appear that under the agreement the products sold by the exclusive licensee are royalty free that there is any need to invoke the covenant. It is because they are royalty free that the law imposes the implied obligation of good faith. To make the very fact which gives rise to the covenant the basis for denying it, is to abrogate the rule itself.

On this point, Judge Frank, in his dissenting opinion said (R. 342-3):

> "I do not believe that, when the parties agreed upon clause 11, they had any such result in mind, that they meant that defendant could thus, in part, place plaintiff's patent on ice. In other words, I do not believe that they intended that, should a court decision narrow the patent claims in any respect, the defendant, still retaining its right to keep plaintiff from using the patent, could itself reduce the sales of the patented device while making and selling a competing article which it had not therefore made and which no one else was making or selling or threatening to make or to sell. Nor can I agree that, on any principle of fairness or public policy, we should, without regard to the parties' actual intention read into the contract a 'constructive' intention to permit such anti-social conduct, which, I think, closely approaches (if, indeed, it does not reach) illegality."

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[7] The Court seems to have applied the same reasoning with respect to the reissue patent to which paragraph Eleventh (b) does not apply. This emphasizes that paragraph Eleventh (b) does not alter the nature of the implied obligation or differentiate this exclusive license from any other exclusive license to which the rule of implied covenant has been applied.

II.

The Court of Appeals was in error in thinking that the implied covenant is repugnant to the *Mercoid* case.

The doctrine of the *Mercoid* case is that a patent owner may not use his patent to restrain or control the use or sale of an unpatented article whether by conditions imposed upon his licensees or otherwise. In that case the patent covered a heating system as a combination. Licenses to install and use that system could only be secured by purchasing a control (an element of the patented combination) from a licensee, and the royalty to be paid by the licensees manufacturing the control was based on the sales price of the unpatented control. Thus the patent on the system was used to obtain a monopoly of the use and sale of the unpatented control and the fact that the royalty was based on the control emphasized that that was the aim.

The covenant to exploit is not repugnant to this doctrine. It does not secure a monopoly of unpatented things. Anyone other than the exclusive licensee is free to make, use or sell a non-infringing substitute for the patented article. And even the exclusive licensee is not prevented from doing so, although under certain carefully defined and limited conditions he may be held answerable in damages to the patent owner if he does. The defined and limited conditions are that if the exclusive licensee adopts a royalty free substitute merely to avoid royalty payments and without any justification in the competitive situation he must pay damages measured by the royalty. Moreover, in this case, and in most cases, the exclusive licensee is given the option of relinquishing his exclusive license and when he does so he becomes freed even of the damage liability.

The damage liability does not arise because a patent license is involved. The rule of implied covenant is one applicable to property rights in general. It is based on principles of good faith and fair dealing. Wherever a party has been entrusted by another with the sole control of the

productiveness of any property the law imposes upon him an affirmative obligation to exploit that property in good faith and if he breaches that obligation he will be held in damages. The key of the matter is that the exclusive grantee has sole control of the enterprise. Having been placed in a position of trust the law holds him answerable for any abuse of that trust. It is unreal to think of the damages for a breach of this trust as a payment of royalty on unpatented devices. It is not that in fact. The covenant merely protects the patent owner by subjecting the licensee to a penalty if he fails to exploit the patented product. Absent such a covenant, the exclusive license is free to abuse his power of control, suppress at will the licensed patents and thus to undermine the public policy stated to be at the basis of the *Mercoid* case. This is pointed out by Judge Frank in his dissenting opinion (R. 343-4; 144 F. (2d) 728):

> "And, cutting across the Paper Bag rule, the courts developed the doctrine of the obligation of an exclusive licensee not to deprive the public of the benefit of the patent. As this latter doctrine promotes the public interest, it is surprising that the defendant should urge that it is inconsistent with, and should be abandoned because of, such recent cases as *Sola Electric Company* v. *Jefferson Electric Company*, 317 U. S. 173, or *Mercoid Corporation* v. *Midcontinent Investment Company*, 320 U. S. 661, or *Nachman Spring-Filled Corporation* v. *Kay Manufacturing Corporation*, 139 F. (2d) 781 (C. C. A. 2), and should quote in favor of its position this statement from the *Mercoid* case: 'The patent is a privilege but it is a privilege which is conditioned by a public purpose.' The decisions cited by defendant, which stress the limited constitutional basis for congressional authorization of patent monopolies, have insisted that patent rights should not be utilized to repress competition unduly. Yet defendant here asserts, with my colleagues' approval, that it may employ its license to reduce competition between types 4 and 7, thereby barring the public from receiving the advantages of the exploitation of plaintiff's patent."

III.

The abrogation of the implied covenant on either ground is a matter of importance in the general administration of the patent law, especially affecting the use of patents and the policy of the law to promote the use of inventions.

The court acted on grounds which make the implied covenant a nullity, and its view of the relationship of this covenant to the *Mercoid* case casts doubt on the legality of the covenant. The uncertainty as to the enforceability of the covenant which the decision creates will affect the willingness of patent owners to grant exclusive licensees, and because prospective licensees frequently will take no other form of license, it will impede the process of getting inventions into use.

The importance of exclusive licenses in encouraging the introduction and extensive use of inventions has recently been given governmental recognition. The Department of Agriculture in a recently issued Patent Manual (Miscellaneous Publication No. 551—U. S. Dept. of Agriculture), referring to the fact that the Secretary has only the power to issue non-exclusive licenses under patents assigned to him, says:

> "It has been found that the nonexclusive feature prevents extensive use of the invention. The marketing of an invention so that it can be used is as important as the making of the invention itself. A recent survey has shown that where a substantial amount of capital is involved in marketing an invention, a manufacturer will be reluctant to invest capital for that purpose unless he is given some measure of protection against competition. This could be done by granting exclusive rights, which the Secretary is not now authorized to do. The enactment of legislation has been advocated that would permit the issuance of exclusive licenses under Government patents for periods long enough to protect invested captial, so that such patents will not become dormant for lack of commercial exploitation."
> (page 14, footnote)

Impairment of this beneficient rule of good faith and fair dealing has another harmful effect. The rule had created one area in the patent law within which, despite the *Paper Bag* case, a patented device could not be shelved. Now a patent license clause commonly employed for a legitimate purpose and which does not affect the fundamental relationship of the parties is so applied as to overthrow the rule of common decency and enthrone the dog in the manger rule of the *Paper Bag* case even between an exclusive licensee and his licensor. The result is that at the exclusive licensee's whim the public may be debarred from receiving the advantage of licensor's patent and the licensor is deprived of his reward, while the licensee continues to profit at the expense of both.

A major change in patent law has been made on what seems a clear error going to the fundamentals of the obligation of good faith.

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Petitioners,

v.

GENERAL MOTORS CORPORATION,

Respondent.

BRIEF FOR RESPONDENT

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BRIEF FOR RESPONDENT

Statement

The petition and supporting brief which have been filed in this case present an entirely unrealistic and incorrect picture of what the issues were in the lower court and how they came about. A brief statement is therefore presented.

The complaint (which was filed on September 26, 1941, (R. 4-6) as limited by the Bill of Particulars as amended (R. 7, 14, 19) originally asserted a single cause of action for the breach of the license agreement of April 1, 1936 (Exh. 1, R. 144-163), because of the alleged failure by respondent, since April 1, 1940, to pay royalties under Paragraph "Sixth" (a) of the agreement (R. 152) with respect to certain *ice trays, for use in electrical refrigerators,* designated as types 2, 3 and 4, claimed to come within the scope

of claims 13 and 17 of licensed patent No. 1,893,535 and claims 8, 9[1] and 14 of licensed reissue patent No. 18,819.[2] The answer denied the allegations of breach and set forth, affirmatively, that the specified claims were limited in scope so as to exclude the accused trays because of file wrapper estoppels (Answer 8, R. 9-10, as amended,[3] R. 15), because of the prior art (Answer 11, R. 12) and by virtue of the application of the provisions of paragraph "Eleventh" (b) of the agreement in view of the limitation placed by Judge Campbell on claims 13 and 17 of patent No. 1,893,535 in his decision of March 8, 1940 (Exh. R)[4] in an action brought in the District Court for the Eastern District of New York and entitled Mechanical Ice Tray Corporation, plaintiff, vs. Abraham Straus, Inc. (Answer 9, R. 10-11 as amended R. 15-16). The answer further alleged that because of such prior decision and the provisions of paragraph "Eleventh" (b), the petitioners were estopped from asserting that the claims in suit of reissue 18,819 embraced or covered the accused trays (Answer 10, R. 11-12).

On the eve of trial in June, 1943 (R. 2), the petitioners in a trial brief and a memorandum of so-called excerpts from cases (copies of which respondent did not see until after the trial began), asserted for the first time a new claim for relief, i. e., the existence, and breach of, implied obliga-

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[1] This claim was added at the trial (R. 271).

[2] The claims of another licensed patent—Reissue No. 21,800—were in issue below but plaintiff has withdrawn the same and no evidence relating thereto has been included in the record, but Findings of Fact Nos. 5[c], 11, 20-22 (R. 293, 295-296, 298-299) and Conclusions of Law, Nos. III, IV (R. 303) were made with respect thereto.

[3] The amendment referred to here and those immediately following were necessary due to the change from claim 18 of patent No. 1,893,535 in the original Bill of Particulars to claim 17 in the amended Bill (R. 19).

[4] This decision (Exh. R) has not been printed in the record by stipulation of the parties (R. 324). It is reported in 31 F. Supp. 938.

tions on respondent to exploit the licensed patents and to refrain from making commercially equivalent devices not covered by the claims. When subsequently pressed at the end of the trial, and on their argument, to state specifically their exact position (see opinion, R. 259-260), the petitioners in an answering and final brief moved "for leave to amend the complaint to conform to the evidence" (see opinion, R. 260). Thereafter the District Judge (Leibell) filed his opinion on September 13, 1943, in which he allowed their motion as follows (R. 260):

> "I shall grant plaintiffs' motion for leave to amend the complaint by pleading a further claim based on an implied obligation on defendant's part to exploit plaintiffs' patents; defendant's attempt to evade that obligation by the manufacture of the *type 4* [1] tray in October, 1940, as a substitute for the type 7 tray; defendant's failure to pay plaintiffs any royalties on the type 4 tray; and plaintiffs' damage resulting from defendant's said conduct."

The judge below then went on to determine the existence and breach of the obligations as he set them forth in the above quotation. On September 25, 1943, petitioners filed their Amendment to the Complaint (R. 20) expressly embodying the substance of the foregoing language of Judge Leibell but *restricting* the alleged breach by the manufacture and sale of type 4 tray as follows:

> "Defendant has breached this implied obligation by adopting commercially equivalent devices, *in particular by substituting its type 4 tray for its type 7 tray*, and by its refusal to pay royalty on such devices."

Thereafter on October 4, 1943, respondent filed an amendment to the answer denying the allegations of the amend-

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[1] Unless otherwise specified, emphasis and matter in brackets in quotations are mine.